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SUBJECT: KAZAKHSTAN - KARACHAGANAK FACES DIFFICULTIES AND OPPORTUNITIES

**¶1.** (SBU) Summary: Kazakhstan's Karachaganak field has large proven reserves of natural gas, but further Karachaganak expansion (i.e., a Phase III) faces obstacles, including administrative delays. The Karachaganak consortium, KPO, maintains that it was recently pressured into paying an environmental fine, as well as to begin paying Kazakhstan's new crude export duty. British Gas recently presented a national gasification strategy to KazMunaiGas (KMG) for developing downstream markets. The strategy was well-received and will be presented at the December Foreign Investors Council meeting.

End Summary.

**¶2.** (U) Karachaganak is one of the world's largest oil and gas condensate fields, covering an area of over 280 square km and holding more than 1.2 billion tons of oil and condensate and 1.35 trillion cubic meters of gas. KPO, Karachaganak's operating consortium, has four international partners: British Gas (BG Group) and Italy's Eni, each with a 32.5 percent interest; Chevron, with a 20 percent stake; and Russia's LUKOIL, with a 15 per cent share. Karachaganak provided 25% of British Gas's annual profit for 2007.

**¶3.** (SBU) KPO's plans for Karachaganak's Phase III expansion anticipate increasing condensate production from 7 million tons per year to 10 million tons and natural gas production from 14 billion cubic feet to 25 billion cubic feet. Kazakhstan's state oil and gas company, KazMunaiGas (KMG), has not yet approved the expansion plans. Peter Flowers, Branch Director for British Gas Kazakhstan, told us on August 20, that KMG would prefer a smaller expansion and has hesitated to approve KPO's proposal. (Note: Under the current PSA revenue-sharing formula, the larger KPO's capital expenditures, the less initial revenue will accrue to the Kazakhstanis. End Note.) Flowers does not expect KMG to grant its approval before the end of this calendar year. If no approval is received by January, the situation would become critical, as KPO must provide advance notification to the Orenburg gas processing facility in order to lock in new gas sales contracts, he explained.

**¶4.** (SBU) According to Flowers and ENI's Resident Manager Claudio Cogliatti, KPO was also recently pressured by the government to pay a large environmental fine and Kazakhstan's new crude export duty, both of which, they contend, it should not have to pay. An environmental fine for 1.8 billion KZT (\$8.5 million) was levied by local tax officials, despite reduced emissions and the company's willingness to pay a smaller fee, Flowers explained. The local authorities, however, refused to accept KPO's proposed lower amount and suspended the consortium's Kazakhstan bank accounts. KPO has appealed the fine and the matter is now pending with the local courts.

**¶5.** (SBU) Flowers claimed that customs officials refused to allow KPO to export gas in July unless the consortium paid the new crude export duty. The consortium initially refused to pay, claiming that its PSA made it exempt and noting that KPO did not appear on the Ministry of Finance's initial list of companies and projects subject to the export duty. (Comment: Prime Minister Masimov relayed a very different story to the Ambassador. He said that unlike Tengizchevroil (TCO), KPO is not exempt from the export duty because, in fact, its PSA does not explicitly provide for an export

duty exemption. He said this fact was discovered in a review of the contract conducted by the GOK's U.S. attorneys and came as a bit of a surprise. End Comment.) Customs officials insisted that KPO pay the duty and, under pressure to meet contractual commitments to clients, KPO ultimately paid the duty for July. Customs officials then reviewed KPO's exports from the previous month and insisted KPO pay for June as well, which they did. To date, KPO has paid \$230 million for three months (June, July, and August), Flowers reported.

KPO has been able to pass along the cost of the export duty through the net back chain, which ultimately means that the Government of Kazakhstan receives a lower return on KPO profits. According to Flowers, KPO is pursuing various means of resolving this dispute and has not ruled out taking the matter to international arbitration in Stockholm.

¶6. (SBU) Flowers said that as part of its broader, long-term strategy in Kazakhstan, British Gas has established a working group with KMG to develop the domestic gas market -- an idea that was well-received by KMG and will be presented at the December Foreign Investors Council meeting. British Gas is proposing to use gas from Kazakhstan, compressing it for utilization in vehicles such as taxis and buses. The pilot phase calls for establishing a network of 6-10 compressed natural gas (CNG) refueling stations in Almaty, where the local government has expressed enthusiasm about using domestic reserves while simultaneously reducing pollution in the city. In addition, KPO itself would convert its 300 buses and vehicles to CNG (Karachaganak spends \$600 million on diesel fuel annually). British Gas and KMG will share a booth to showcase the project (together with a CNG Mercedes-Benz) at the Kazakhstan International Oil and Gas Exhibition (KIOGE) in October.

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